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Neil E. Harl

Iowa State University, harl@iastate.edu

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THE PRESENT INTEREST TEST FOR PURPOSES OF SPECIAL USE VALUATION

— by Neil E. Harl*

Since publication of the initial regulations,¹ the Internal Revenue Service has maintained that real property was eligible for special use valuation only if a qualified heir received a *present interest* from the decedent.² Two branches of the present interest test have emerged.

Discretionary trusts. One branch of the present interest test has involved discretionary trusts in which trustees have a discretionary spray power or a discretionary right to invade principal to benefit individuals in addition to those holding the income interest. The presence of trustee discretion has the potential to undercut the right of the holder of the income interest.

The IRS originally took the position that, for the present interest test to be met, there must be no discretion in paying income or principal to the qualified heir or heirs.³ Moreover, if an estate representative had discretion in allocating estate assets, and a beneficiary of one interest did not have a present interest, the position of IRS was that no assets (either real or personal) subject to discretionary allocation by the estate representative were eligible to meet the threshold requirements of eligibility for special use valuation.⁴

The IRS position produced a storm of protest and on April 27, 1981, IRS announced that discretionary payment of income or principal would not make land ineligible for special use valuation if all actual and potential beneficiaries were members of the decedent's family.⁵ Later, the Economic Recovery Tax Act of 1981 addressed the problem retroactive to January 1, 1977, by making interests in a discretionary trust present interests *if all beneficiaries are qualified* heirs.⁶ Thus, for trusts to meet this branch of the present interest test — (1) it must be a discretionary trust and (2) all beneficiaries must be members of the decedent's family⁷ which is required for qualified heir status.⁸

Successive interests. If successive interests are created in property by the decedent, the IRS position has been that all of the interests must vest in qualified heirs and all of the interests must be specially valued if any part is

valued under special use valuation.¹⁰ If interests pass to non family members, special use valuation is precluded.¹¹ Likewise, leaving a remainder interest to a charitable organization precludes special use valuation for life interests left to eligible family members.¹² And if a life estate is bequeathed to a qualified heir with a special power to appoint the remainder to other than qualified heirs, special use valuation is precluded.¹³ If the qualified heir disclaims the special power with the result that the remainder interest vests in a qualified heir, the land is eligible for special use valuation.¹⁴

A major concern has been whether a contingent devise of land to a charitable organization or to non family members (for example on failure of a spouse or issue to survive) subject to a low probability of vesting ownership in the charitable organization or non family member would bar a special use value election. For several years, the IRS position was that such a contingent devise would preclude a special use value election.¹⁵ The result has been the same, and special use valuation is denied if a qualified heir purchased the interest of a non eligible devisee before the property actually passed to the non eligible taker.¹⁶ Thus, it was generally recommended that all interests vest at the death of a property owner in family members or vest in the last surviving member of the decedent's family if special use valuation was desired.

A series of cases beginning in 1986 have rejected the IRS position on the successive interest branch of the present interest test insofar as the IRS position barred a special use value election where an extremely low probability existed that property interests could pass to non family members. Three Tax Court cases¹⁷ held the regulation invalid and permitted special use valuation elections where the probabilities were low that ineligible parties might acquire an interest in real property for which a special use value election was sought. The Fourth¹⁸ and the Seventh¹⁹ Circuits have indicated basic agreement with that position. The Internal Revenue Service now agrees, also.²⁰

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

FOOTNOTES

- ¹ Treas. Reg. § 20.2032A-3(b)(1).
- ² See, e.g., Ltr. Rul. 8244001, Jan. 14, 1981. See generally 5 Harl, **Agricultural Law** § 43.03[2][d][iii] [E],[F] (1991).
- ³ Ltr. Rul. 8020011, Feb. 7, 1980.
- ⁴ Ltr. Rul. 8114033, Dec. 31, 1980; Ltr. Rul. 8244001, Jan. 14, 1981.
- ⁵ IR-147, April 27, 1981.
- ⁶ Pub. L. 97-34, Sec. 421(j)(l), amending I.R.C. § 2032A(g).
- ⁷ I.R.C. § 2032A(e)(2).
- ⁸ I.R.C. § 2032A(e)(1).
- ⁹ Treas. Reg. § 20.2032A-8(a)(2). See Ltr. Rul. 8249012, Aug. 23, 1982 (successive interests in farmland all received by qualified heirs).
- ¹⁰ Treas. Reg. § 20.2032A-8(a)(2). See Ltr. Rul. 8249012, Aug. 23, 1982 (successive interests in farmland all received by qualified heirs).
- ¹¹ Ltr. Rul. 8044018, July 30, 1980 (remainder interest to non family members precluded special use valuation for life estate to spouse); Ltr. Rul. 8435007, April 24, 1984 (remainder interest passed to both qualified and non qualified heirs; special use valuation not allowed); Ltr. Rul. 8337015, June 7, 1983 (trustee discretion to distribute to non family member barred special use valuation).
- ¹² Rev. Rul. 81-220, 1981-2 C.B. 175.
- ¹³ Ltr. Rul. 8349008, Aug. 23, 1983.
- ¹⁴ Rev. Rul. 82-140, 1982-2 C.B. 208.
- ¹⁵ Ltr. Rul. 8441006, June 26, 1984. See Treas. Reg. § 20.2032A-8(a)(2) (precludes special use value election if property interests vest in family member subject to being divested in favor of non family member). Compare Ltr. Rul. 8321007, Feb. 2, 1983 (vested remainder interest subject to being divested did not preclude special use valuation) with Ltr. Rul. 8332012, April 22, 1983 (special use valuation disallowed because of low probability that property could pass to non qualified heir); Ltr. Rul. 8346006, July 29, 1983 (same); Ltr. Rul. 8349008, August 23, 1983 (same).
- ¹⁶ Ltr. Rul. 8407006, Nov. 9, 1983 (under agreement, qualified heir received land and charity received cash but treated by IRS as purchase by qualified heir from charity).
- ¹⁷ Est. of Davis v. Comm'r, 86 T.C. 1156 (1986) ("exceedingly remote" chance that property would pass to non qualified heir; regulation invalid); Est. of Pliske v. Comm'r, T.C. Memo. 1986-311 (same); Est. of Clinard v. Comm'r, 86 T.C. 1180 (1986) (regulation invalid to extent election precluded where qualified heir possessed life estate and special power of appointment).
- ¹⁸ Est. of Thompson v. Comm'r, 864 F.2d 1128 (4th Cir. 1989).
- ¹⁹ See Smoot v. Comm'r, 892 F.2d 597 (7th Cir. 1989), *aff'd*, 88-1 U.S.T.C. ¶ 13,748 (C.D. Ill. 1987) (special use election allowed where only remote possibility that contingent remainder interest in farmland could pass to non qualified heir and where surviving spouse had limited power of appointment exercisable in favor of non qualified heirs; exercising power in favor of persons who are not qualified heirs would make power holder liable for recapture tax on interests so appointed).
- ²⁰ Ltr. Rul. 8643005, July 18, 1986 (special use valuation allowed where chance remote that person who was not qualified heir would receive land). See Ltr. Rul. 8713001, Dec. 3, 1986 (special use valuation allowed where chance of non qualified heirs receiving interest in land removed by state law presumptions that remainder interests vested in life interest holders as soon as possible).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

EASEMENT BY PRESCRIPTION. The plaintiff claimed an easement by prescription over the defendant's road used by the plaintiff to haul timber. The court held that the only evidence plaintiff provided of adverse use of the road, actions to widen the road, were insufficient to overcome the presumption that the use was permissive. The court cited testimony of the plaintiffs that permission from the defendants was sought in past years to work on the road and that the plaintiffs never claimed any right to the

road before the instant suit. **Hollis v. Tomlinson**, 585 S.2d 862 (Ala. 1991).

ANIMALS

ESTRAYS. The defendant was convicted under Ariz. Rev. Stat. § 24-246(A) for shooting a stray horse owned by a neighbor. The defendant argued that Ariz. Rev. Stat. § 24-246(D) provided an absolute defense in that the horse was an estray. The court held that the exception provided by Section 246(A) applied only to the "taking up" of